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FEDERAL COMMUNICATIONS COMMISSION
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IN THE MATTER OF)

CC DOCKET NO. 94-1

PRICE CAP PERFORMANCE REVIEW)
FOR LOCAL EXCHANGE CARRIERS)

**COMMENTS OF
THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE**

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Summary

The Commission's goals for the price caps rules will drive the resolution of the baseline and transitional issues. The local exchange and access service markets are not now effectively competitive, and probably will not be so for the foreseeable future. Accordingly, the Commission should seek to adjust its price caps rules so that the rules produce a result as close to the competitive condition result as possible.

Certainly, the Commission should not modify its LEC price caps rules in ways which would give the LECs an unfair advantage in building the telecommunications infrastructure of the future. If price caps rules give the LECs such an advantage, the LECs' monopoly position could be perpetuated, or at least extended. Perpetuation or extension of the current monopoly condition will not yield, to the maximum extent possible, the innovation that in turn will enhance our Nations' competitiveness and create economic growth. The experience of at least the last twenty-five years confirms irrefutably that policies which promote telecommunications competition are the best bet for encouraging innovations and cost reductions.

The Commission should not amend its LEC price caps rules to eliminate sharing or to allow the LECs to earn higher returns before sharing is required. If anything, the Commission should reexamine the earning levels that the LECs currently may enjoy before sharing is required. The cost of raising capital and debt has declined since the Commission adopted its LEC price caps

rules. The suggestion that LECs be required to share earnings with their customers at a lower earnings level is not inconsistent with incenting LECs to operate more efficiently. Price caps regulations should seek to replicate competitive market conditions. In competitive markets, competition forces companies to continually improve their efficiency. Companies operating in such markets are not guaranteed enhanced profitability simply because they have become more efficient. They must continue to improve their efficiency to survive. The Commission's price caps rules should continue to press the LECs to become more efficient, and to mimic, to the extent possible, the operation of the competitive market. Sharing continues to be good public policy.

The Commission also should examine the LECs' input costs in calculating the productivity factor which should be used in the price caps formulas. As shown in the attached Analysis, which was prepared by ETI, the current productivity factor is too low. It should be increased to replicate the competitive condition. Failure to increase the productivity factor would give the LECs a Commission sanctioned advantage over other companies in the race to build the telecommunications infrastructure of the future. Indeed, failure to increase the productivity factor could favor the LEC's vision of the infrastructure over competing technologies.

Finally, the Commission should not adopt transition rules at this time. It is far too early to know whether, and if so the

extent to which, the local exchange and access service markets will become effectively competitive. if such a condition occurs, the relevant LEC access services can be removed from price caps regulation. Until then, Commission vigilance is required.

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In the Matter of)
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Price Cap Performance Review) CC Docket No. 94-1
for Local Exchange Carriers)

**COMMENTS OF
THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE**

The Ad Hoc Telecommunications Users Committee ("Ad Hoc Committee" or "Committee") hereby comments on the issues raised in the Commission's Notice of Proposed Rulemaking^{1/} initiating its fourth year review of the performance of local exchange carriers under price cap regulation.

I. INTRODUCTION

This proceeding is exceptionally consequential for all users of telecommunications services because of its potential effects on telecommunications rates generally, as well as on the future of exchange access and local exchange service competition. To assist in the Commission's evaluation of the important questions posed in the NPRM, the Ad Hoc Committee retained Economics and Technology, Inc. to prepare a detailed analysis of the key economic and policy questions surrounding price cap performance review (the "ETI Analysis"). These comments are based upon and summarize the ETI Analysis, a copy of which is appended as Attachment A.

^{1/} In the Matter of Price Cap Performance Review for Local Exchange Carriers, Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 94-10, rel. February 16, 1994 (the "NPRM").

II. THE COMMISSION'S CENTRAL POLICY GOAL FOR REGULATION OF LECs SHOULD CONTINUE TO BE TO REPLICATE COMPETITIVE CONDITIONS, NOT TO ATTEMPT TO ENGINEER INDUSTRIAL POLICY

The threshold, and possibly most important, question to be resolved in this proceeding is whether the Commission will accede to the blandishments of those who contend that the goals of the price cap plan should be enlarged to include construction of the so-called National Information Infrastructure ("NII"), and who argue that to promote such objectives the Commission afford LECs the opportunity to earn even greater profits. The Commission should not make such a bargain. Rather, the Commission should adhere to goals and mechanisms that are designed to achieve competitive results, to further the growth of competition and to allow actual consumer demand and marketplace forces to shape development of broadband and other services of the future.

A. General Issue 1: The Basic "Competitive Result" Goal Of Price Cap Regulation Should Be Maintained, And Price Cap Rates Must Be Subject To Review In Order To Achieve That Goal.

Fundamental competitive, marketplace and technological conditions have not changed sufficiently since 1991 to warrant revision of the basic goals of price cap regulation, to relax enforcement of pricing constraints, or to lessen the need for close regulatory supervision of price cap rates. The Committee agrees with the Commission's conclusion that "the basic goals of

price caps remain valid",^{2/} and is of the view that rigorous price cap rate review and regulation continue to be essential to achieve the competitive result goal.

As discussed in further detail in the ETI Analysis, the central goal of economic regulation is to achieve a "competitive result" in industries and markets in which some degree of "market failure" precludes such a result absent regulation. In the case of telecommunications and many other "public utility" type services, the regulatory solution to market failure conditions has been to impose a form of financial regulation in which monopoly earnings, defined in terms of "return on investor supplied capital", would be constrained to that level which would prevail were the same capital invested in "competitive" industries exhibiting comparable levels of risk and liquidity. Traditionally, such constraints have been imposed by way of rate of return regulation. While the Commission's price cap regime supplements the pure "earnings" basis underlying rate of return regulation with a focus on price levels, even a cursory examination of the Commission's price cap rules reveals a clear intention that the basic goals of economic regulation -- establishment of just and reasonable rates at competitive levels

^{2/} NPRM at ¶ 33. "The goals of price cap regulation . . . include ensuring that LEC rates are just, reasonable and nondiscriminatory, and promoting a communications system that offers innovative, high quality services." Id. at ¶ 31.

-- remained unaltered by price caps.^{3/} Indeed, as the Commission stated in the NPRM, "[t]he effect of capping prices rather than profits is to replicate the marketplace forces of competition."^{4/} Accordingly, until such time as marketplace forces are sufficient to discipline the pricing of LEC access services, the bedrock "competitive result" objective of economic regulation is not -- and should not be -- modified or diminished under price cap or other forms of incentive regulation, and all proposals for revision of the basic price cap system should be evaluated in terms of their consistency with this fundamental goal.

Thus, the Commission must reject revisionist LEC depictions of price cap regulation as an irrevocable departure from traditional rate of return regulation, and should recognize that because LECs continue to dominate and exercise monopoly power in the exchange access marketplace, affording LECs additional pricing flexibility under price caps regulation would disserve the competitive result goal. The Commission should also reject the notion that periodic review of price cap levels and regulations amounts to a reversion to rate of return regulation or is somehow unfair to or more burdensome to LECs than pricing

^{3/} For example: "going in" price cap rate levels based on traditional rate of return parameters; annual price cap adjustments, offset by growth in LEC productivity, intended to simulate conditions that would prevail under "normal" rates of return; the "consumer dividend" and "sharing mechanism" limiting LEC earnings to competitive levels keyed to traditional rate of return parameters.

^{4/} NPRM at ¶ 12.

constraints imposed by the marketplace in competitive industries. In fact, nothing could be further from the truth. Price caps was never intended to obviate scrutiny of carrier earnings and, in competitive industries where earnings and price adjustment mechanisms are subject to constant "review" by the marketplace, there is no expectation that an efficiency gain by any particular participant will afford it perpetual profit gains. Without efficiency gains survival is in question in many industries.

The price caps mechanism should serve a similar purpose to marketplace review, adapting to the fluid nature of markets and industries without altering the basic competitive result goal. More specifically, the Ad Hoc Committee urges the Commission to adopt revisions to the present price cap regime that will:

- Accommodate periodic changes in industry productivity to reflect the revolutionary changes taking place in telecommunications technology and demand growth.
- Accurately reflect changes in price levels confronted by LECs for the inputs (capital, labor, materials) they actually purchase rather than retain the present economy-wide inflation index which measures changes in output prices for all goods and services in the economy as a whole.
- Simulate the diffusion of efficiency gains on an ongoing basis through retention -- and perhaps even expansion -- of the sharing requirement.
- Reflect fundamental changes in prevailing costs of money so as to confront LECs with the same types of capital market conditions that would exist for firms in competitive industries.
- Maintain effective safeguards to prevent "gaming" of the price cap mechanism itself through self-serving depreciation increases and strategic investment programs whose costs are charged against "shareable

earnings" but whose benefits flow primarily to the LECs' owners.

B. General Issue 2: Perceptions of "Linkage" Between Price Caps And Broad Economic Objectives Are Illusory, Ill-Conceived, And Ignore Other Relevant Factors.

Under General Issue 2, the Commission seeks comment on the historical effects of the price cap plan on consumer welfare, the economy, and the creation of jobs both in telecommunications and other sectors of the economy, and requests parties to project future effects of the price caps plan and possible price cap plan revisions on these national macroeconomic issues as well.

While efforts will no doubt be made by interested parties to attribute various events and conditions in the telecommunications industry and the economy generally to price cap regulation, it will prove extremely difficult, probably impossible, to sustain such attributions with credible evidence. LECs will likely respond to this issue with studies extolling a positive relationship between the LECs' perception of effective price cap regulation -- premised on the argument that one of the fundamental goals of price cap regulation should be to promote investment in the telecommunications infrastructure -- and the general future well-being of the U.S. economy. Such studies can be expected to conclude that telecommunications infrastructure investment will produce a variety of economic benefits for the nation.

There are at least several major problems with such studies and arguments. To begin with, no clear "cause and effect" relationship exists between telecommunications

infrastructure investment and general economic growth in a mature, highly developed economy such as that of the United States. Research conducted by ETI based upon sophisticated causality statistical methods indicates that although such a causal link is found in developing economies, because a "threshold telecommunications infrastructure" is essential for such economies to grow, no specific cause and effect relationship seems to flow from marginal enhancements to the world's most advanced telecommunications system on the one hand, to macroeconomic economic improvement on the other hand.

Commission pursuit of an industrial policy to direct investment in telecommunications infrastructure with the intended purpose of benefitting employment and the economy generally would be misguided, imprudent and perhaps illegal. Even assuming, notwithstanding the contrary finding of ETI's analysis, that some minor absolute macroeconomic gains could be expected to flow from investment in the telecommunications sector, in the context of a government-sponsored industrial policy aimed at directing investment toward a particular market sector -- the policy potentially inherent in the Commission's framing of General Issue 2, a relevant assessment must be based not on absolute results but on relative gains derived from investment in telecommunications infrastructure as compared with alternative investments of the same resources.

For example, LEC arguments for maintaining the X factor at its current unreasonably low level focus on the assumed

benefits of the investments the LECs purportedly are making (or will make) in telecommunications infrastructure, and the eventual potential effects of such investment on productivity generally. Omitted from such analyses are the beneficial effects which would flow to the general economy were the LECs to lower prices to business and consumers by way of a higher X factor, rather than diverting excess revenues into telecommunications infrastructure investment. Using a widely recognized and highly regarded macroeconometric model developed by Nobel price economist Larry Klein, the ETI Analysis shows that a policy of maintaining an inappropriately low X factor for the purpose of increasing investment has no immediate measurable beneficial effect on the macroeconomy when the true simultaneous nature of economic relationships is taken into account, and that the eventual net effect of such a "tax"^{5/} on the output of the macroeconomy after five years is negative.^{6/}

Meaningful evaluation of any government-sponsored industrial investment program requires a cost/benefit comparison with alternative investment programs. While the LECs will argue

^{5/} As shown in the ETI Analysis, a government policy that artificially inflates the price of services in a given sector to achieve some defined purpose (here, establishing excessive access prices in order to finance LEC expansion) is the economic equivalent of an excise tax, and the effect of such a "tax and invest" policy is modeled accordingly as if the deliberately understated X factor were a tax.

^{6/} Specifically, the analysis shows that government-sponsored telecommunications infrastructure investment financed by an X factor one percent lower than normal has a net negative effect on the macroeconomy after five years of 0.53 billion dollars.

that investment in the information superhighway infrastructure is of paramount importance to the national economy, equally persuasive cases can be made for investment in, among other things, education, health, highways, airports and computer technology.^{7/} It is also necessary that the relative benefits of industrial policy vs. private sector use of resources (which, of course, may also include investment) be considered. Even within the telecommunications sector it is far from clear that the best use of any investment set aside of economic resources lies in earmarking such resources for investment by LECs as opposed to other industry participants. Similarly, it is essential that Commission price cap policies guard against clearly uneconomic infrastructure investment financed through an inappropriately low X factor.^{8/} To the extent such uneconomic investments as LECs have proposed for broadband and video switching and delivery plant are facilitated by price cap

^{7/} Indeed, several of these areas (e.g., education) are more correctly viewed as "public" functions, and as more appropriate candidates for government intervention in an investment allocation capacity than, for example, video dialtone services which essentially provide entertainment, a commodity more appropriately supplied by private market forces.

^{8/} Pending RBOC applications for Section 214 authority to construct video dialtone facilities exemplify the uneconomic investment problem. These applications fail to demonstrate how the applicants can recover the massive investments proposed for construction of fiber and coaxial facilities in the local loop without relying on subsidies from basic service ratepayers. See, Ad Hoc Committee Petition to Deny Application of Pacific Bell (W-P-C-6913) filed February 14, 1994; Ad Hoc Committee Petition to Deny Applications of Ameritech (W-P-C-6926 through W-P-C-6930) filed March 11, 1994.

regulation, the consequent adverse effects upon the general economy must be weighed against, and could readily overshadow, any minor benefit derived from a government-sponsored telecommunications infrastructure investment program.

Stripped of rhetorical trappings, LEC arguments in favor of maintaining a lower than normal productivity offset to provide for overall gains in the national economy propose government intervention to extract money from residential and business consumers of telecommunications services now (in the form of excessive LEC rates) in the hope of generating speculative and uncertain future benefits from consequent LEC investments. Such decisions are best left to the marketplace.

C. Baseline Issue 1: A Fully Competitive Market Structure Should Be The Preferred Paradigm For The NII

Closely related to General Issues 1 and 2, Baseline Issue 1 deals directly with infrastructure development. Baseline Issue 1a specifically inquires "[w]hether, and if so how, the Commission should revise the LEC price cap plan to support the development of a ubiquitous national information infrastructure."^{2/} As should be evident from the Ad Hoc Committee's comments in response to General Issues 1 and 2, the Committee believes revising basic elements of the LEC price cap plan in an effort to support development of the NII to be an ill conceived endeavor. Because private risk capital and market-based decision making represent the best way to efficiently

^{2/} NPRM at ¶ 36.

allocate resources in a market economy, the Commission can most effectively assist in the development of a ubiquitous national information infrastructure by continuing its laudable efforts to promote competition in the local infrastructure.^{10/} While a few measures helpful to development of the NII might be incorporated into the price cap system,^{11/} it would be a serious mistake and misuse of the price caps regime to modify the existing price cap sharing mechanism, depreciation policies, or other regulations bearing on the LECs' financial condition in order to create additional financial incentives for accelerated LEC deployment of facilities underlying the "local links" of the national information infrastructure, and a grave error to prescribe targets for deployment by price cap LECs of specific technologies into the local infrastructure, such as fiber optic or coaxial cable facilities. The bottom line is that consumers, not the FCC, should define the demand for broadband and other information

^{10/} See, Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369 (1992), modified on recon., 8 FCC Rcd 127 (1992), modified on second recon., 8 FCC Rcd 7341 (1993), petitions for recon. pending, appeal pending sub nom. Bell Atlantic Corp. v. FCC, No. 92-1619 (D.C. Cir., filed Nov. 25, 1992); Transport Rate Structure and Pricing, CC Docket No. 91-213, 7 FCC Rcd 7006 (1992), petition for recon. pending, modified on recon., 8 FCC Rcd 5370 (1993), modified on second recon., 8 FCC Rcd 6233 (1993), petitions for recon. pending, appeal dismissed sub nom. New England Tel. and Tel. Co. v. FCC, No. 93-1494 (D.C. Cir. Sept. 7, 1993), appeal pending sub nom. Full Service Computing Corp. v. FCC, No. 93-1670 (D.C. Cir. filed Oct. 1993).

^{11/} These measures would be primarily in the area of monitoring LEC investments and deployment practices.

services and, to the extent feasible, marketplace forces should be allowed to operate so that the competing service providers and alternative technologies proving most efficient in meeting that demand ultimately prevail, thereby defining the parameters of the NII in response to actual demand and marketplace forces rather than government fiat or LEC caprice. The Ad Hoc Committee endorses the view recently expressed by House Telecommunications Subcommittee Chairman Edward Markey in this regard:

Constructing the information superhighway will not depend upon large communications colossi trying to maintain the ability to charge monopoly rates, but rather upon the competitive search by entrepreneurs for services that the consumer actually demands.^{12/}

Such a marketplace approach to development of the NII is consistent with the Ad Hoc Committee's position in response to General Issue 1 that the fundamental and overriding goal of the LEC price cap plan must remain to achieve as closely as possible a "competitive result." In contrast, implementing price cap plan revisions intended to allow LECs to earn excessive profits with the misguided view that such profits will be employed in development of the NII will only tend to ensure that the LECs will continue to effectively monopolize the local exchange and exchange access markets. By implementing any type of positive, stimulative linkage between the financial constraints of the LEC price cap plan and LEC deployment of advanced network technologies, the Commission would in effect be creating an industrial policy that will take the nation down the road of

^{12/} Communications Daily, April 7, 1994, Vol. 14, No. 67, p. 3.

centralized, monopolistic development of the national information infrastructure.

As discussed in detail in the ETI Analysis, there are essentially only three basic models for development of the NII: (a) a private competitive model (private, risk-taking, entrepreneurial investment governed by marketplace forces); (b) a private natural monopoly, or public utility model (conferred upon the LECs or, alternatively, cable operators); (c) a public model (an NII built and managed by public authorities, as in the case of highways, airports, postal services, etc.). As further demonstrated in the ETI Analysis, these alternatives are as a practical matter mutually exclusive, and granting the franchised monopoly provider (here, the LECs) a leading role in development of the NII, where that role is backed by revenues from regulated, non-competitive services (as would occur in the case of any affirmative linkage to the price caps system), is incompatible with the private risk capital, entrepreneurial approach.^{13/} There is likely to be little support for pursuing a public model (alternative (c)), and while alternative (b) may be preferable to (c) because experience teaches that private profit-oriented management typically does a better job than public administration of a business activity, there is little to choose between these

^{13/} Conversely, selection of the entrepreneurial approach will necessarily require that LEC entry into advanced telecommunications markets will need to be carefully circumscribed and monitored.

models with respect to efficacy of resource allocation and potential for competition and innovation.

In a market economy, use of private risk capital and market-based decision making is the most efficient method for allocating society's resources except under very special circumstances, and policies that mandate or encourage centralized monopolistic development of telecommunications infrastructures, whether by private or public entities, can be justified only where one or both of two economic conditions hold true: (1) "natural monopoly" economies of scale and/or scope are sufficient to outweigh dynamic gains available through innovation and competition as well as the societal risks of centralized, non-market based investment decisions; (2) there is insufficient private risk capital available to finance investments required. As demonstrated in the ETI Analysis, neither of these economic conditions apply to the future development of the U.S information infrastructure.

For a "natural monopoly" model to succeed in the development of an advanced telecommunications infrastructure two circumstances must be present: (1) a stable underlying technology; and (2) predictable market demand. Only if these circumstances are present can the gains from the static efficiencies of a natural monopoly (economies of scale and scope) overcome the risks of locking in a technology or misjudging demand. One need look no further in resolving this issue than to observe that perhaps the single most prominent feature of modern

telecommunications technology is the profusion of multiple competing technologies. "Last mile" access may be provided by twisted pair copper, coaxial cable, any of a profusion of existing and developing wireless technologies, fiber optic cable, or combinations of these technologies. Even the seemingly essential element of the information highway, "broadband" network transmission and switching facilities, finds itself in competition with digital compression technologies and solutions.^{14/} As for predictability of demand, the generally lukewarm response to experiments with interactive services conducted to date, combined with widely publicized doubts as to who will really want access to, or be able to effectively use, a "500 channel" universe, lead to the inevitable conclusion that actual demand for advanced telecommunications services at this juncture is highly uncertain.^{15/}

The second economic condition required to overcome the presumption that use of private risk capital and market-based

^{14/} Indeed, at the very same time Pacific Bell, Ameritech and others are seeking 214 authority to provide video dialtone services by expending huge sums for extending a mix of fiber and coaxial plant to the home, Bell Atlantic proposes an Asymmetric Digital Subscriber Line (ADSL) based video dialtone service using existing copper pair facilities without requiring additional loop facilities and installation investments. See, Pleading Cycle Established For Comments On Bell Atlantic's Petition For Waiver Of § 64.702(e), Public Notice, DA 94-373, rel. April 25, 1994.

^{15/} As discussed in the ETI Analysis, Pacific Bell's recently announced plans for a pilot project to test the use of broadband fiber optic transmissions to be used for "real time" distribution of motion picture films to movie theaters in California suggests deployment of technology in search of a use. ETI Analysis, p. 39.

decision making is the most efficient method for allocating society's resources (i.e., the absence of available private risk capital) is similarly inapplicable. There is no evidence that development of the national information infrastructure is threatened by a lack of private risk capital. To the contrary, the accelerating pace of investments in information technology and related markets appears to strongly contradict such a possibility. In 1993, for example, electronic information services grew 16 percent to an estimated \$13.6 billion.^{16/}

In an address to the National Press Club on May 2, 1994, on the "development of the information highway" Chairman Reed E. Hundt gave welcome affirmation to the competitive paradigm, stating:

I do not believe that the public wants government to pick its favorite network for development [of the information highway]. The public does not want government to choose among different proposals for technological innovation of the networks. I agree with the public. Instead, competition should determine who wins. Our role is to referee the game.

A fully competitive market structure is the preferred paradigm for building a national information infrastructure and, to

^{16/} U.S. Industrial Outlook 1994, U.S. Department of Commerce (January 1994), p. 25-2. As discussed in further detail in the ETI Analysis, arguments by proponents of a linkage between price caps and infrastructure development that evolution of the NII will proceed too slowly without government intervention should be rejected. Government intervention (or support backed by ratepayers of existing monopoly services) should be applied incrementally and limited to circumstances where the government must "fill the gap" because marketplace is unable to satisfy demand directly (e.g., access by schools, hospitals and other agencies). ETI Analysis, p. 43.

effectively "referee the game", the Commission must ensure that its LEC price cap rules and regulatory strategies are consistent with the competitive model.^{17/}

D. Baseline Issue 2A: The Commission Should Not Change The Basket and Band Rules.

Generally, price cap LECs already possess sufficient pricing flexibility. The Commission should not amend the basket and band rules. If future competition justifies affording the LECs additional pricing flexibility, modification of the current baskets and bands can be considered with the particular factual contexts then presented. The Commission already has granted LECs the freedom to develop Zone Density Pricing Plans to respond to facilities based competition from Competitive Access Service Providers. The existing rules also allow price cap LECs to price below band based upon sufficient showing. The Ad Hoc Committee certainly does not oppose LEC competitive pricing when actual conditions warrant additional pricing flexibility. If and when such conditions evolve, appropriately targeted pricing flexibility may be warranted. A general restructuring of the

^{17/} The ETI Analysis cites the example of the CPE market for vividly demonstrating the highly "customer-oriented" nature of a competitive marketplace, concluding that because a large part of the uncertainty surrounding advanced telecommunications services is determining precisely what customers will want (and be willing to pay for), it is critical to the development of these services that competitive conditions be extended as far as possible. Only in those circumstances where it is clearly evident that there is an unfulfilled customer demand (market failure) should government intervene to "fill the gap." ETI Analysis, p. 36.

current baskets and bands, however, is not warranted by current market conditions.

E. Baseline Issue 3: Experience Gained Under Price Caps Regulation To Date Indicates That The X Factor Should Be Significantly Increased; Current Price Cap LEC Profit Levels Are Grossly Excessive.

Baseline Issue 3 solicits comments on possible changes in the productivity factor and price cap rate levels. The Ad Hoc Committee's comments will address Baseline Issue 3a (whether the productivity factor should be changed), Baseline Issue 3c (if so, what method should the Commission use to determine a revised and reasonable productivity factor) and, finally, Baseline Issue 3b (are the price cap LECs' profit levels reasonable).

Experience under price caps regulation at both the federal and state levels demonstrates that the 3.3% X factor is unreasonably low and unnecessarily generous to the LECs, resulting in access rate levels far exceeding those that would prevail under a "competitive result" economic model. The X factor therefore should be significantly increased. Demonstrating in some detail the need for an increase in the X factor, the ETI Analysis reviews each of its three components: (1) LEC input price growth rate; (2) LEC "total factor" productivity growth rate; and (3) the consumer productivity dividend, sometimes referred to as the "stretch factor."

- (i) The growth rate of LEC input prices is substantially lower than the growth rate of national inflation.

Currently, the Commission's price caps plan for LECs is premised on a measure of inflation represented by the Gross National Product price index, or GNP-PI, an index of output prices not necessarily reflective of the input prices actually paid by LECs for labor, materials and capital equipment, and includes a productivity offset, or X factor, premised on the assumption that LEC input prices rise faster than the GNP-PI. To test this assumption against actual experience operating under price caps, ETI conducted detailed empirical economic studies involving LECs in seven states.^{18/} These tests show that the assumption is erroneous. Rather than rising faster than the GNP-PI, LEC input prices rise an average of one percentage point more slowly than the GNP-PI. Moreover, and as further detailed in the ETI Analysis (pp. 50-52), the validity of ETI's conclusion that LEC input prices rise more slowly than the GNP-PI has been expressly recognized by the California and Pennsylvania public utilities commissions, and has been conceded by Illinois Bell in a proceeding before the Illinois Commerce Commission.

^{18/} The states analyzed are California, New York, Pennsylvania, Delaware, Illinois, Indiana and Ohio.